

Message Text

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PAGE 01 LIMA 03018 01 OF 02 072308Z
ACTION ARA-14

INFO OCT-01 ISO-00 SS-15 SP-02 INR-10 INRE-00 NSCE-00
CIAE-00 TRSE-00 EB-08 SSO-00 /050 W
-----048975 080053Z /70 S
O 072219Z APR 78
FM AMEMBASSY LIMA
TO SECSTATE WASHDC IMMEDIATE 9505

C O N F I D E N T I A L SECTION 1 OF 2 LIMA 3018

E.O. 11652: GDS
TAGS: EFIN EGEN PE
SUBJ: PERU'S ECONOMY: CURRENT SITUATION AND PROSPECTS

REF: A. LIMA 2866, B. LIMA 2943

1. SUMMARY: THIS CABLE ATTEMPTS TO SUMMARIZE DEVELOPMENTS
IN THE PERUVIAN ECONOMY OVER THE PAST FEW YEARS AND
PROSPECTS FOR THE PERIOD AHEAD. THE MOST STRIKING NEGATIVE
DEVELOPMENT IS THE PUBLIC DEBT BURDEN OF OVER
\$4.3 BILLION, WITH DEBT SERVICE PAYMENTS UP FROM \$474
MILLION (36.7 0/0 OF EXPORTS) IN 1975 TO A PROJECTED \$1,004
MILLION (50.8 0/0 OF EXPORTS) IN 1978; CURRENTLY SCHEDULED
DEBT SERVICE FOR 1981 (I.E., NOT INCLUDING ANY RE-
SCHEDULING OF SOVIET DEBT, THE \$260 MILLION PRIVATE
BANK PACKAGE, OR OTHER PUBLIC DEBT) IS \$1,113 MILLION
OR 37 0/0 OF PROJECTED EXPORTS. ATTEMPTS BY GOP SINCE 1975
TO STABILIZE ECONOMY SHOW MIXED RESULTS: THE
TRADE BALANCE HAS IMPROVED DRAMATICALLY FROM A DEFICIT OF \$1.1
BILLION IN 1975 TO SLIGHTLY OVER \$400 MILLION IN
1977, PREDICTED ROUGH BALANCE THIS YEAR AND MODERATE
SURPLUS THEREAFTER. EXCHANGE RATE POLICY, DESPITE THE
CURRENT IMPASSE WITH THE IMF, HAS ALSO BEEN LARGELY
SUCCESSFUL, WITH OVER 60 PERCENT DEVALUATION SINCE LAST
OCTOBER; FURTHER CRAWL OR FLOAT TO THE CURRENT FREE
FLOATING DOLLAR CERTIFICATE RATE WOULD ENTAIL AN
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PAGE 02 LIMA 03018 01 OF 02 072308Z

ADDITIONAL 25-30 PERCENT. NEGATIVE ASPECTS OF
STABILIZATION EFFORTS INCLUDE MEASURES TO BRING
PUBLIC SECTOR DEFICIT INTO LINE (8.5 0/0 OF GDP IN 1976,
8.6 0/0 IN 1977, AND 3.3 0/0 IN 1978 IF REPEAT IF IMF TARGET
IS MET), AN INFLATION RATE LIKELY TO REMAIN IN THE
30-40 PERCENT RANGE THIS YEAR, AND RELUCTANCE
OF THE GOP TO MOVE ON INSTITUTIONAL IMPEDIMENTS TO

ECONOMIC RECOVERY, SUCH AS INDUSTRY, AGRICULTURE, AND LABOR LAWS.

2. A NOTEWORTHY, PERVERSE EFFECT OF THE IMF STABILIZATION PROGRAM, WITH ITS EMPHASIS ON GLOBAL TARGETS FOR PUBLIC FINANCE AND INTERNATIONAL RESERVES, HAS BEEN THE GOP TENDENCY TO FOLLOW THE LEAST PAINFUL ROUTE, SQUEEZING THE PRIVATE RATHER THAN THE PUBLIC SECTOR, AND INVESTMENT RATHER THAN CONSUMPTION: BETWEEN 1975 AND 1977 PUBLIC CONSUMPTION WAS UP 10 0/0, PRIVATE CONSUMPTION WAS UP 2 0/0, PUBLIC INVESTMENT WAS DOWN 33 0/0, AND PRIVATE INVESTMENT WAS DOWN 18 0/0. A LONGER TERM RECOVERY PROGRAM LEADING TO RENEWED GROWTH AND DEVELOPMENT WOULD HAVE TO REVERSE THESE TRENDS. ANOTHER KEY NEGATIVE ELEMENT IN GOP ECONOMIC PERFORMANCE IS THE APPARENT LACK OF STRONG, COMPETENT LEADERSHIP IN DEALING WITH THE ECONOMIC CRISIS. PRESIDENT MORALES BERMUDEZ FEELS HE HAS TO GOVERN ON THE BASIS OF CONSENSUS AMONG THE GENERALS AND ADMIRALS, BUT THIS IS A SLOW-MOVING PROCESS WHERE SOUND ECONOMICS OFTEN LOSE OUT TO SPECIAL INTERESTS AS WELL AS SOCIAL PRESSURES. A STRONG, PUBLIC CREDIBLE ECONOMIC TEAM WOULD GO SOME WAY TOWARD RESTORING SUPPORT AND DYNAMISM TO THIS CRIPPLED NATIONAL ECONOMY.

3. A MORE FUNDAMENTAL QUESTION IS WHETHER A POOR
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PAGE 03 LIMA 03018 01 OF 02 072308Z

COUNTRY SUCH AS PERU, DESPITE SUBSTANTIAL NATURAL RESOURCES AND ASSUMING THE BEST POLITICAL WILL, CAN POSSIBLY OVERCOME THE ENORMOUS FOREIGN DEBT ACCUMULATED IN THE EARLY AND MID-1970S WITHOUT TOTAL UPHEAVAL OF THE POLITICAL AND SOCIAL STRUCTURE. PERHAPS THE ONLY POINT OF ECONOMIC POLICY ON WHICH THERE IS CONSENSUS CUTTING ACROSS ALL ELEMENTS OF THE POLITICAL SPECTRUM IN PERU IS THAT SOME ADJUSTMENT IS REQUIRED IN THE INTERNATIONAL ECONOMIC ORDER TO OVERCOME THE UNPRECEDENTED FINANCIAL IMBALANCE OF THIS DECADE RESULTING FROM THE OIL CRISIS, WORLD RECESSION, OVERZEALOUS PRIVATE BANK LENDING AND, IN THE CASE OF PERU, THE IRRESPONSIBLE SPENDING PROGRAMS OF THE VELASCO REGIME. BUT SUCH CHANGES IN THE INTERNATIONAL ORDER, HOWEVER DESIRABLE, ARE LONGER-RUN CONSIDERATIONS, AND PERU IN THE SHORTER TERM CLEARLY REQUIRES SOME FORM OF RESTRUCTURING OF ITS FOREIGN DEBT WHICH USES HALF OF THE COUNTRY'S EXPORT EARNINGS TO MEET ITS FOREIGN OBLIGATIONS.
END SUMMARY.

4. INTRODUCTION: MISSION BELIEVES THAT AS PERU MOVES DEEPER AND DEEPER INTO CHRONIC FINANCIAL CRISIS IT IS

USEFUL TO PRESENT A BROADER VIEW OF THE PERUVIAN ECONOMIC SITUATION IN ORDER TO GIVE SOME PERSPECTIVE ON HOW THE SITUATION HAS EVOLVED SINCE FIRST STABILIZATION EFFORTS BEGAN IN 1975. IN THIS MESSAGE WE DESCRIBE FOLLOWING BASIC FACTORS IN PERUVIAN ECONOMY: EXTERNAL DEBT, FOREIGN TRADE, EXCHANGE RATE, PUBLIC SECTOR BUDGET, INFLATION, INSTITUTIONAL IMPEDIMENTS AND CONSUMPTION VERSUS INVESTMENT IN PUBLIC AND PRIVATE SECTORS.

5. EXTERNAL DEBT SERVICE. TOTAL EXTERNAL DEBT SERVICE ON PERU'S PUBLIC SECTOR DEBT FOR 1978 (BASED ON DATA GIVEN PRIVATE FOREIGN BANKS BY GOP IN JANUARY MEMO) IS ESTIMATED AT \$1,003.6 MILLION. THIS IS BROKEN DOWN
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PAGE 04 LIMA 03018 01 OF 02 072308Z

AS FOLLOWS:

	AMORT.	INTEREST	TOTAL
INTERNATIONAL ORGANIZATIONS	20.0	22.5	42.5
OFFICIAL GOVERNMENT AGENCIES	100.00	47.0	147.0
LOANS WITH EXPORT CREDIT			
INSURANCE	161.8	56.6	218.4
COMMERCIAL BANKS	259.2	122.8	382.0
SOCIALIST COUNTRIES	98.1	26.4	124.5
SERVICE FOR CREDITS NOT YET			
CONTRACTED	9.8	9.8	
TOTAL	639.0	285.2	924.2
BANK LOANS FOR BALANCE OF			
PAYMENTS SUPPORT	47.1	32.2	79.4
GRAND TOTAL	686.2	317.4	1003.6

OF THIS AMOUNT, ABOUT \$405 MILLION (OR 40.4 0/0) IS DUE TO BE PAID TO U.S. SOURCES, BOTH OFFICIAL AND PRIVATE. THIS BREAKS DOWN AS FOLLOWS:

EXIM BANK	\$6.7 MILLION
AID	3.7
CCC	52.9
FMS	11.8
PRIVATE	330.0

MOREOVER, IN COMING YEARS SERVICE OF PERU'S PUBLIC SECTOR DEBT (EVEN BEFORE TAKING ACCOUNT OF RESCHEDULED PRIVATE BANK, SOVIET, ETC. DEBT NOW UNDER DISCUSSION) APPEARS TO REMAIN AT THESE HIGH LEVELS: 1979 -- \$1,096 MILLION; 1980 -- \$1,121 MILLION; 1981 -- \$1,113 MILLION; AND 1982 -- \$1,116 MILLION. (SOURCE: GOP
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PAGE 05 LIMA 03018 01 OF 02 072308Z

NOVEMBER 1977 PRESENTATION AND JANUARY 1978 MEMORANDUM TO PRIVATE U.S. BANKS.) AS A PERCENTAGE OF PROJECTED PERUVIAN EXPORTS (PROVIDED IN THE JANUARY MEMORANDUM) THESE PUBLIC SECTOR DEBT SERVICE PAYMENTS WOULD BE: 1978 (50.8 0/0), 1979 (48.5 0/0), 1980 (42.9 0/0), 1981 (37.1 0/0), 1982 (34.1 0/0).

6. FOREIGN TRADE. ONE POSITIVE AREA OF PERUVIAN ECONOMIC PERFORMANCE SINCE THE BEGINNING OF STABILIZATION EFFORTS IN 1975 IS FOREIGN TRADE, WHERE THE NEGATIVE TRADE BALANCES HAVE GRADUALLY BEEN REDUCED. THE FOLLOWING TABLE, PROVIDED BY THE GOP IN ITS JANUARY MEMORANDUM TO FOREIGN BANKERS, PRESENTS PERU'S TRADE BALANCES FROM 1975 TO 1979 (ALL DATA IN MILLIONS OF U.S. DOLLARS):

	EXPORTS (FOB)	IMPORTS (FOB)	BALANCE
1975	1,290.9	2,390.1	-1,099.2
1976	1,359.5	2,100.0	-740.5
1977	1,725.6	2,131.2	-405.6 #
1978	1,975.6	1,920.0	PLUS 55.6
1979	1,260.2	1,900.0	PLUS 360.2

(#LATEST ESTIMATE IS THAT BOTH EXPORTS AND IMPORTS IN 1977 SHIFTED DOWN WITH TRADE BALANCE IN -440 MILLION DOLLAR RANGE.)

7. EXCHANGE RATE POLICY. DESPITE CURRENT IMPASSE WITH IMF, THE GOP HAS MAINTAINED A GENERALLY REALISTIC EXCHANGE RATE POLICY, ALLOWING A THREE-FOLD DEVALUATION OF THE SOL FROM 43/\$ IN 1975 TO 130/\$ IN EARLY 1978, INCLUDING A 60 PERCENT DEVALUATION SINCE OCTOBER 1977. THIS DRAMATIC FALL IN THE VALUE OF THE SOL SHOULD BE BOORNE IN MIND WHEN ASSESSING GOP PERFORMANCE IN CONTROLLING INFLATION (SEE PARA 9 BELOW). MOREOVER, THERE IS THE POSSIBILITY OF AN ADDITIONAL 25-30 PERCENT DEVALUATION IF THE EXCHANGE RATE RESUMES ITS MOVEMENT

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PAGE 06 LIMA 03018 01 OF 02 072308Z

(EITHER THROUGH CRAWL OR FLOAT) FROM THE CURRENT

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PAGE 01 LIMA 03018 02 OF 02 072324Z
ACTION ARA-14

INFO OCT-01 ISO-00 SS-15 SP-02 INR-10 NSCE-00 CIAE-00
TRSE-00 EB-08 SSO-00 INRE-00 /050 W
-----049257 080055Z /70 S
O 072219Z APR 78
FM AMEMBASSY LIMA
TO SECSTATE WASHDC IMMEDIATE 9506

C O N F I D E N T I A L SECTION 2 OF 2 LIMA 3018

130/\$ RATE TO THE FREE FLOATING DOLLAR CERTIFICATE RATE
(BETWEEN 165-170/\$).

8. PUBLIC SECTOR BUDGET DEFICIT. ANALYSIS IF PUBLIC
SECTOR BUDGET DEFICITS DURING RECENT YEARS INDICATES
A MAJOR INCREASE IN 1975 FROM THE AVERAGE OF THE YEARS
1970-1974. FROM 1970 TO 1974 THE PUBLIC SECTOR DEFICITS
AVERAGE 4.3 PERCENT OF GDP. THIS PERCENTAGE INCREASED TO
10.4 PERCENT IN 1975, BUT IT HAS DECREASED SOMEWHAT TO 8.5 PERCENT
IN 1976 AND 8.6 PERCENT IN 1977. THESE FIGURES INDICATE THAT
THE GOV HAS TRIED SINCE 1976 (SINCE THE IMPOSITION OF
THE FIRST STABILIZATION PROGRAM) TO REDUCE THE PUBLIC
SECTOR DEFICIT, BUT IT APPEARS THAT THE GOVERNMENT'S
EFFORTS HAVE NOT BEEN SUFFICIENT. THE IMF TARGET WAS
TO REDUCE THE PUBLIC SECTOR DEFICIT TO 3.3 PERCENT IN 1978.

9. INFLATION. ON THE NEGATIVE SIDE PERU HAS EXPERIENCED
INCREASED RATES OF INFLATION OVER THE PAST FEW YEARS.
BASED ON THE CONSUMER PRICE INDEX FOR THE GREATER LIMA
AREA, ANNUAL RATES OF INFLATION HAVE BEEN AS FOLLOWS:

1974	16.9 PERCENT
1975	23.6
1976	33.5 PERCENT
1977	38.0 PERCENT

BASED ON DATA (ADMITTEDLY LIMITED) FOR THE FIRST MONTHS
OF 1978, IT IS PROBABLY REASONABLE TO ASSUME AT LEAST A
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PAGE 02 LIMA 03018 02 OF 02 072324Z

30-40 PERCENT ANNUAL RATE FOR THIS YEAR. WHILE THESE INFLATION
RATES ARE HIGHER THAN HISTORICAL RATES FOR PERU, IT IS
WORTH NOTING THAT THERE HAS BEEN A LEVELING-OFF TENDENCY
DURING THE PAST TWO OR THREE YEARS, DESPITE SUCH

INFLATIONARY FACTORS AS DRAMATIC DEVALUATION OF THE SOL
AND THE PHASE-OUT OF SUBSIDIES ON BASIC FOODSTUFFS.

10. INSTITUTIONAL IMPEDIMENTS. AMPERING ANY RECOVERY
HAS BEEN THE GOP'S RELUCTANCE TO TAKE SIGNIFICANT STEPS
TO MODIFY SOME OF THE INSTITUTIONAL STRUCTURES ESTABLISHED
IN THE REVOLUTION'S FIRST PHASE WHICH DEMORALIZED THE
PRIVATE SECTOR AND ADVERSELY AFFECTED PRODUCTION. THE
GOP DELAYED UNTIL FEBRUARY 1977 BEFORE CHANGING THE
INDUSTRIAL COMMUNITY LAW, WHICH ORIGINALLY PROVIDED FOR
EVENTUAL WORKER OWNERSHIP AND MANAGEMENT OF INDUSTRIAL
FIRMS. SIMILARLY THE GOVERNMENT SPENT TWO YEARS
DELIBERATING ON THE RECENT CHANGES TO THE LABOR STABILITY LAW
WHICH HAS IN THE PAST MADE IT ALMOST IMPOSSIBLE TO DISMISS WORKERS
FOR ANY CAUSE. THE GOVERNMENT HAS STATED PUBLICLY THAT IT
WILL NOT ALTER THE AGRARIAN REFORM LAW, EVEN THOUGH THERE
IS CONSIDERABLE SUPPORT FOR THE THESIS THAT THE LAW
IS PARTLY RESPONSIBLE FOR THE STAGNATION IN AGRICULTURAL
PRODUCTION IN THE LAST 8 YEARS. APART FROM SELLING
OFF THE PERUVIAN FISHING FLEET, THE GOP HAS ALSO MOVED
SLOWLY IN DISMANTLING OR REORGANIZING ANY PARASTATAL
AGENCIES, MANY OF WHICH ARE OPERATING AT HUGE DEFICITS.
THE GOP INACTION ON THE INTEREST RATE STRUCTURE HAS
BEEN ONE OF THE FACTORS IN THE LOW LEVEL OF DOMESTIC
SAVING. WHERE THE GOP HAS ACTED, SUCH AS IN THE
MODIFICATIONS TO THE INDUSTRIAL COMMUNITY LAW (TO
PERMIT INVESTORS TO RETAIN MAJORITY CONTROL AND IN
LABOR STABILITY TO PROVIDE BROADER GROUNDS FOR WORKERS'
DISMISSAL), THE ATTEMPTS TO BE ATTENTIVE TO PRIVATE
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PAGE 03 LIMA 03018 02 OF 02 072324Z

INVESTORS HAVE BEEN TEMPERED BY A DESIRE TO ASSUAGE
LABOR. CONSEQUENTLY INVESTORS HAVE NOT BEEN OVERLY
REASSURED BY WHAT THEY VIEW AS HALF-HEARTED MEASURES,
AND THE PRIVATE SECTOR INPUT NEEDED TO SPARK A RECOVERY
HAS NOT MATERIALIZED.

11. INVESTMENT VS. CONSUMPTION AN IRONIC, EVEN
PERVERSE, RESULT OF PERU'S STABILIZATION AUTHORITY
PROGRAM HAS BEEN THE INORDINATE SQUEEZE ON INVESTMENT,
BOTH IN THE PUBLIC AND PRIVATE SECTORS. FOR EXAMPLE,
IMF CREDIT TARGETS ARE AGGREGATE ONES, AND THE GOP
IN DETERMINING WHERE RESTRICTIONS SHOULD BE GREATEST,
HAS SHOWN A TENDENCY TO SQUEEZE THE PRIVATE RATHER THAN
THE PUBLIC SECTOR, AND TO REDUCE INVESTMENT RATHER THAN
CONSUMPTION. THUS, BETWEEN 1975 AND 1977 PUBLIC SECTOR
CONSUMPTION (E.G. WAGES AND SALARIES) WAS UP BY SOME
TEN PERCENT AND PRIVATE SECTOR CONSUMPTION WAS UP BY
ONLY TWO PERCENT, WHILE PUBLIC SECTOR INVESTMENT DECLINED
33 PERCENT AND PRIVATE INVESTMENT, ALREADY DEPRESSED BY

THE ABOVE-MENTIONED INSTITUTIONAL DISINCENTIVES TO PRIVATE INVESTMENT WHICH MARKED THE FIRST PHASE (1968-1975) OF THE REVOLUTIONARY MILITARY GOVERNMENT, WAS DOWN BY 18 PERCENT (ALTHOUGH THESE DATA ARE FROM GOP PROJECTION OF SECOND HALF 1977 AND NOT FROM THE LATEST NATIONAL ACCOUNTS WHICH RUN THROUGH 1976 ONLY--THE MAGNITUDES OF CHANGE PROBABLY WILL NOT BE ALTERED SUBSTANTIALLY BY THE FINAL DATA.) CLEARLY A MEDIUM TO LONG-TERM RECOVERY PROGRAM WOULD HAVE TO REVERSE THESE TRENDS IN ORDER TO ENCOURAGE RENEWED PRIVATE AND PUBLIC SECTOR INVESTMENT.

12. COMMENT: AS NOTED ABOVE, THE GOVERNMENT'S RELUCTANCE TO MOVE DECISIVELY IN CERTAIN AREAS HAS HAMPERED THE COUNTRY'S ABILITY TO DEAL WITH THE ECONOMIC CRISIS. THIS APPLIES NOT ONLY TO THE RESTRUCTURING OF SOME OF REVOLUTIONARY REFORMS BUT ALSO TO THE IMPLEMENTATION OF THE STABILIZATION PROGRAMS, BOTH THE SELF-IMPOSED STABIL-
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PAGE 04 LIMA 03018 02 OF 02 072324Z

IZATION PROGRAM OF 1976 AND THE STANDBY AGREEMENT WORKED OUT WITH THE IMF IN 1977. THE APPARENT LACK OF LEADERSHIP IN CONFRONTING THE PROBLEMS RESULTS TO A LARGE EXTENT FROM PRESIDENT MORALES BERMUDEZ BELIEF THAT HE HAS TO GOVERN ON THE BASIS OF CONSENSUS AMONG THE SENIOR GENERALS AND ADMIRALS, BUT THIS IS A SLOW-MOVING PROCESS, AND SOUND ECONOMIC POLICIES OFTEN LOSE OUT TO SPECIAL INTERESTS. THIS MODUS OPERANDI HAS BEEN REINFORCED BY THE GOV'S CONCERN TO AVOID SOCIAL UNREST AND THE POSSIBLE NEED FOR REPRESSIVE MEASURES IF CONFRONT WITH STRIKES OR OTHER POPULAR MANIFESTATIONS OF DISCONTENT. WHILE THE GOV DESERVES CREDIT FOR ITS EFFORTS TO MAINTAIN A GOOD HUMAN RIGHTS RECORD UNDER THE DIFFICULT ECONOMIC CONDITIONS, THE APPARENT VACILLATION IN CARRYING OUT URGENTLY NEEDED ECONOMIC MEASURES HAS ERODED CONFIDENCE ON THE PART OF LOCAL INVESTORS AND FOREIGN BANKERS, ALREADY DOUBTFUL ABOUT THE ABILITIES OF THE CURRENT ECONOMIC TEAM, HEADED BY AN ARMY GENERAL WHOSE PREVIOUS ASSIGNMENT WAS COMMAND OF AN ARMORED BRIGADE. A STRONG, NEW ECONOMIC TEAM, HEADED BY A RESPECTED CIVILIAN WITH SOLID TIES TO THE FINANCIAL COMMUNITY, WOULD GO SOME WAY TO RESTORING SUPPORT AND DYNAMISM TO THIS CRIPPED ECONOMY.

13. BUT EVEN ASSUMING A CHANGE IN THE ECONOMIC TEAM AND THE BEST POLITICAL WILL, THERE REMAINS A MORE FUNDAMENTAL QUESTION OF WHETHER A TROUBLED COUNTRY SUCH AS PERU, DESPITE SUBSTANTIAL NATURAL RESOURCES, CAN POSSIBLY OVERCOME THE ENORMOUS FOREIGN DEBT ACCUMULATED IN THE 1968-1976 PERIOD WITHOUT A TOTAL UPEHAVAL OF THE POLITICAL AND SOCIAL STRUCTURE. PERHAPS THE ONLY POINT OF ECONOMIC POLICY ON WHICH THERE IS CONSENSUS CUTTING ACROSS ALMOST ALL ELEMENTS OF

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REQUIRED IN THE WORLD ECONOMIC ORDER TO OVERCOME THE UNPRE-
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PAGE 05 LIMA 03018 02 OF 02 072324Z

CENDENTED FINANCIAL IMBALANCE OF THIS DECADE RESULTING FROM
THE OIL CRIS, WORLD RECESSION, WHAT IS PERCEIVED AS OVER-
IRRESPONSIBLE BORROWING AND SPENDING PROGRAMS OF THE
VELASCO REGIME. BUT THE EFFECTS OF SUCH FAR REACHING
CHANGES IN THE INTERNATIONAL ECONOMIC SYSTEM IF UNDERTAKEN
WOULD NOT BE FELT FOR SOME TIME, WHILE WHAT PERU CLEARLY
NEEDS IN THE SHORTER TERM IS TO RESCHEDULE FOREIGN DEBT
WHICH NOW OBLIGATES PERU TO DEVOTE HALF ITS EXPORT
EARNINGS TO PUBLIC SECTOR DEBT SERVICE.
SHLAUDEMAM

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Message Attributes

Automatic Decaptioning: X
Capture Date: 01 jan 1994
Channel Indicators: n/a
Current Classification: UNCLASSIFIED
Concepts: ECONOMIC CONDITIONS, ECONOMIC TRENDS, ECONOMIC DATA
Control Number: n/a
Copy: SINGLE
Draft Date: 07 apr 1978
Decaption Date: 01 jan 1960
Decaption Note:
Disposition Action: RELEASED
Disposition Approved on Date:
Disposition Case Number: n/a
Disposition Comment: 25 YEAR REVIEW
Disposition Date: 20 Mar 2014
Disposition Event:
Disposition History: n/a
Disposition Reason:
Disposition Remarks:
Document Number: 1978LIMA03018
Document Source: CORE
Document Unique ID: 00
Drafter: n/a
Enclosure: n/a
Executive Order: GS
Errors: N/A
Expiration:
Film Number: D780151-0731
Format: TEL
From: LIMA
Handling Restrictions: n/a
Image Path:
ISecure: 1
Legacy Key: link1978/newtext/t19780481/aaaacrcf.tel
Line Count: 405
Litigation Code IDs:
Litigation Codes:
Litigation History:
Locator: TEXT ON-LINE, ON MICROFILM
Message ID: a19ed4b4-c288-dd11-92da-001cc4696bcc
Office: ACTION ARA
Original Classification: CONFIDENTIAL
Original Handling Restrictions: n/a
Original Previous Classification: n/a
Original Previous Handling Restrictions: n/a
Page Count: 8
Previous Channel Indicators: n/a
Previous Classification: CONFIDENTIAL
Previous Handling Restrictions: n/a
Reference: 78 LIMA 2866, 78 LIMA 2943
Retention: 0
Review Action: RELEASED, APPROVED
Review Content Flags:
Review Date: 25 jul 2005
Review Event:
Review Exemptions: n/a
Review Media Identifier:
Review Release Date: n/a
Review Release Event: n/a
Review Transfer Date:
Review Withdrawn Fields: n/a
SAS ID: 3043329
Secure: OPEN
Status: NATIVE
Subject: PERU'S ECONOMY: CURRENT SITUATION AND PROSPECTS
TAGS: EFIN, EGEN, PE
To: STATE
Type: TE
vdkgvwkey: odb://SAS/SAS.dbo.SAS_Docs/a19ed4b4-c288-dd11-92da-001cc4696bcc
Review Markings:
Sheryl P. Walter
Declassified/Released
US Department of State
EO Systematic Review
20 Mar 2014
Markings: Sheryl P. Walter Declassified/Released US Department of State EO Systematic Review 20 Mar 2014